3500 GUIDELINES FOR AUDITING UNITY

Unitary examinations are, by their nature, very fact intensive. Furthermore, the facts and circumstances will be unique in each case and even the relevance or weight attached to a particular unitary factor will vary in each case. This environment has several implications for the auditor. First, it is essential that the auditor and the supervisor make a judgement as to whether the potential deficiency or overassessment will justify the resources that will be necessary to adequately develop and support the unity issue. Second, the auditor must obtain a good overall understanding of the taxpayer's business before focusing on the details of the unitary relationships so that questions and information requests can be tailored to the specific taxpayer. Finally, the auditor must be prepared to present all of the relevant facts objectively. The importance of unitary factors may only be put into perspective when viewed in conjunction with the overall activities of the business. Therefore, to prevent the taxpayer from altering the unitary perspective at the protest or appeal level by presenting additional facts that were not rebutted at audit, the complete picture needs to be presented and explained in the audit report.

Reviewed: December 2002

3505 GENERAL CONDUCT OF THE AUDIT

The following guidelines are applicable to all audits, but are especially important for a successful audit of unity:

Reviewed: December 2002

3510 What Is Evidence?

Taxpayers can produce two types of evidence to support their contentions: (1) contemporaneous objective evidence, and (2) testimonial evidence.

Contemporaneous objective evidence:

Contemporaneous objective evidence is evidence fully supported by written documentation. At the appeal or litigation level, if the taxpayer produces contemporaneous objective evidence to support its unitary position, and if the FTB is unable to rebut that evidence, the taxpayer will prevail.

Contemporaneous objective evidence may include but is not limited to:

Internal office memoranda between key personnel and managers of either the parent or subsidiary. This may show a subsidiary's degree of autonomy from or dependence upon the parent.

External office memoranda between the key managers of the parent and the subsidiary. Who is making day-to-day operating decisions? Who is making major operating decisions? Who conducts the subsidiary's negotiations with outsiders, and who binds the subsidiary contractually?

Third party written communications regarding the subsidiary's transactions with outsiders.

Contemporaneous objective evidence will either corroborate the taxpayer's story or create FTB's side of the story. General requests such as for "correspondence that pertains to the relationship between the parent and subsidiary" may create an opportunity for a taxpayer to provide the auditor only the documents the taxpayer chooses to disclose. The auditor should therefore become familiar enough with the taxpayer's business to be able to request specific documentation. For example, the auditor should identify the potential strong central managers or key individuals of the parent, or autonomous officers of the subsidiary, and should review their business correspondence files. Information obtained from the correspondence files can also be used to develop specific interview questions for that individual or for others with whom that manager corresponds.

Testimonial evidence:

Key personnel of the taxpayer, by testimony, state certain matters to be as they believe them to be. This becomes the "story" of the taxpayer. Unless the FTB can offer another side of the story that is supported by documentation, the taxpayer's "story" will be controlling on the issue of unity.

A significant part of the evidence is likely to be testimonial. The FTB is charged with the responsibility of determining whether the taxpayer's story is correct or whether there is another side to the story.

The best chance for discovering the other side to the story is at the audit level. Therefore, the auditor must often try to anticipate the arguments or testimony that the taxpayer is likely to make so that the documentation necessary to overcome the testimony will be in the audit file.

Reviewed: December 2002

3515 When Is Documentation Sufficient?

At what point has the auditor accumulated enough information to support an audit adjustment involving unity? The answer to this question will be different in each case, but the general guideline is that the auditor must develop enough facts to have a clear understanding of the relationships between the entities or activities. Although the auditor and taxpayer may interpret the facts differently, there should be agreement on the underlying facts.

The amount of documentation that is necessary may vary tremendously depending upon the fact pattern. In an extreme example, assume that a subsidiary sells 100% of its product to the parent corporation. This strong a unitary tie will almost always cause the corporations to be unitary. If the auditor is seeking to combine the entities, it will probably be sufficient to document the intercompany sales, and obtain a general enough understanding of the taxpayer's business to be comfortable that there are no extenuating circumstances that would preclude unity.

As another example, assume that a taxpayer publishes different editions of a magazine with the same title in the United States and in a foreign country. Although this is a factor that suggests a unitary relationship, it is not conclusive of unity. The auditor needs to develop enough information about the business to have a good understanding of the flows of value that are really taking place (e.g., are the same articles printed in both editions, are there common advertisers, is printing technology shared, etc.). If the taxpayer later provides documentation that highlights only the areas where the operations are autonomous, the FTB needs to be able to rebut the taxpayer's arguments with facts that demonstrate that the overall operations are unitary.

Finally, assume that a commonly owned group of corporations is engaged in diverse business operations, and asserts the presence of strong centralized management coupled with centralized departments. A unitary examination under these conditions will require in-depth development of the facts concerning managerial relationships and other flows of value that may be very difficult to quantify. This is one of the most difficult and time-consuming types of unitary examination.

When presenting the facts in the audit narrative, the auditor should avoid using generalizations and labels such as "common purchasing" or "centralized accounting," and should instead describe the manner in which the functions are integrated, the extent of the centralization, the benefits derived by the integration, and the significance of the unitary tie in relation to the overall operations. This point is discussed in more detail in MATM 3040. In addition to describing the centralized or integrated functions, the auditor should also describe the functions that each entity or business segment performs for itself, and explain how these functions impact or co-exist with any alleged centralization for the same or similar functions.

The auditor should state the facts, as they exist. Auditors should not take weak facts and make them seem more important in the audit narrative. The auditor also should not leave facts out of the report if they seem to weaken the case for unity or nonunity. There is a perception that developing these facts is the responsibility of the taxpayer rather than the auditor. The reality, however, is that facts that support the taxpayer's position will invariably be brought up at the protest level, and at that point they may be given greater or less emphasis than they deserve. Therefore, the auditor is responsible for getting the facts and presenting all the facts in the audit file.

Reviewed: December 2002

3520 How Much Documentation Is Necessary If The Case Is Agreed?

Occasionally, taxpayers will agree to an adjustment to their method of filing before the factual development has been completed. It is difficult to expect a taxpayer to undergo the inconvenience and expense of a detailed unitary audit after they have already agreed to the adjustment. On the other hand, there have been instances where taxpayers have protested cases that were believed to have been "agreed." It may be difficult for the department to sustain these cases if the factual development is incomplete. To protect the state's interests while minimizing the inconvenience to the taxpayer, unitary adjustments resulting in a deficiency which are supported by incomplete factual development may only be made if the taxpayer provides a written statement with the following components:

1. the taxpayer's agreement to the adjustment, and

2. an acknowledgement that if the adjustment is protested or if a claim for refund is subsequently filed, the case will be returned to the auditor so that the audit may be completed.

The auditor is responsible for obtaining the appropriate amount of preliminary information prior to accepting such an agreement. It is at the discretion of the auditor as to the amount of preliminary information that is required and is based on the facts and circumstances of each case.

The statement should be signed by an officer or other individual with the authority to bind the taxpayer.

(See MATM 2800 and Exhibit K).

Reviewed: December 2002

3525 Recording The Paper Trail

The volume of information pertinent to these audits dictates that detailed workpaper files be kept, and that the information be clearly indexed and cross-referenced. Interview questions and IDRs should be cross-referenced to responses so that the reader can follow the actions that have been taken. Relevant data should be summarized and cross-referenced to the source documents in the file. Guidelines for setting up the audit package and cross-referencing files are discussed in MATM 2490.

Whenever possible, copies of all documentation relevant to the auditor's determination should be included in the file. In some cases however, the documentation is too voluminous to be easily copied. In such situations (and only if the auditor does not feel that the information is important to the case), the auditor should write a memo to include in the file for support. The memo should describe the document, including the name or title of the document, the date it was issued, the number of pages, and a description of the contents. In addition, the auditor should obtain a photocopy of the title page of the document for the audit file. If applicable, the name of the person who prepared the report and the distribution of the report might be identified. The relevant information from the document should be described, and a list of the applicable page numbers should be identified. In the event that it becomes necessary to request the actual document at the protest, appeal or litigation level, the auditor should also note the name and title/position of the person to contact regarding the document, and where it is maintained.

Occasionally, taxpayers will allow auditors to look at documents in their offices but will refuse to allow auditors to photocopy the documents (or to provide the auditor with photocopies). Auditors are entitled to photocopy documents. If the auditor is unable to obtain cooperation, the auditor and supervisor should contact the Multistate Specialist or International Specialist for assistance. Further suggestions for dealing with uncooperative taxpayers are discussed in MATM 3530.

Reviewed: December 2002

3530 Partial Responses And Demands For Information

It is not uncommon for auditors to experience problems with taxpayers providing only partial responses, which do not satisfy the IDRs. Auditors must then decide whether it is appropriate to issue a demand letter or whether it would be better to wait for the next response. This is often a difficult decision because of the conflicting goals of (1) maintaining a good working relationship with the taxpayer, and (2) maintaining control of the audit. In most cases however, the auditor should recognize that if the taxpayer is providing incomplete information, there is not a good working relationship already. It is usually better to document and monitor lack of cooperation as soon as it is suspected so that the taxpayer is immediately aware that such practices are not acceptable.

Auditors should recognize that uncooperative behavior may sometimes be more subtle than an express refusal to provide information. Taxpayer's representatives will sometimes attempt the following behaviors in order to control the progress of an audit:

- being vague about setting a time for the inspection of books and records;
- allowing only limited access or a trickling disclosure to records;
- absences of qualified personnel from the taxpayer's offices at the time of set appointments;
- absence of certain books and records due to their alleged necessity in other parts of the taxpayer's operation;
- limiting hours of inspection by late morning appointments, long lunch hours, and early closings;
- refusing to supply primary sources of information, thereby causing the auditor to accept something less than primary information;
- attempting to dictate to the auditor the records pertinent to the audit; or
- attempting to dominate the auditor with claims that the requests for information are irrelevant, immaterial and inapplicable to the audit.

It is very important that the auditor confront the taxpayer's representative as soon as possible with detailed evidence of the lack of progress. The actions of the representative that impaired the progress of the audit should also be memorialized in a letter to the taxpayer's representative, and be clearly documented in the file.

If the auditor has any doubt about what documents the taxpayer will provide and an out-of-town trip is involved, the taxpayer should be asked whether he intends to supply the documents before the auditor makes the trip. In this manner, the auditor may be able to save wasted time on a trip for which no documents are provided.

The auditor should make every effort to obtain the information necessary to conduct the audit and support its conclusions and recommendations. In most instances, requests for information should be in writing, and should contain only a single question or single issue per individual IDR. The need and relevance of the information should be clearly communicated to the taxpayer. If the specific information requested does not exist or is overly burdensome for the taxpayer to provide, the taxpayer should be asked if alternative documents exist which will provide the substantiation that the auditor needs. The information requests must establish the time frames within which the information is to be furnished. When requested information is not provided or is unreasonably delayed, the auditor should reevaluate the relevance and need for the information before making a formal demand. Is the request reasonable? Has the information already been provided in an alternative form? Is the information necessary to decide the issue? Is the taxpayer's failure to provide the requested information due to reasonable cause?

In order to support this type of audit, it is critical that the file contains a good record to support the fact that the taxpayer was uncooperative. The audit file should document the reasons why the information requested from the taxpayer was necessary for a proper audit determination. Since the auditor's rationale for asking particular questions may not be obvious several years later as the case is protested, appealed or litigated, this explanation will prevent the taxpayer from successfully arguing that the questions were unreasonable.

The unsatisfied aspects of each information document request should be regularly monitored so that timely demands or subpoenas can be issued. The fact that a taxpayer has provided some of the information requested in an IDR does not preclude the department from issuing demand letters and ultimately a failure to furnish penalty with respect to the remaining information. For example, if a taxpayer is given an IDR requesting five items, and only items 2, 4 and 5 are provided, the auditor may issue a demand for items 1 and 3. Without this audit trail, subpoenas are unlikely to be issued, and the failure to furnish penalty will be difficult to support.

The use of single-question or single-issue IDRs is one method for issuing IDRs that will help to avoid receiving partial responses. Wherever possible the auditor should limit requests for specific documents to one per IDR. Similarly, requests for information or narrative-type responses should be limited to one question or one group of issue-related questions. In the event that the IDR requests are unanswered, use of the single question or single issue format will allow the auditor to send follow-up requests for each unanswered IDR. Separate IDRs make it easier to document the history of a request (i.e., date of the original request, follow-up dates, extensions granted, etc.) in the event that the auditor recommends a failure to furnish information penalty be assessed.

The department's policy for issuing demand letters and failure to furnish information penalties is stated in MAPM 8040. Foreign parent situations create special problems, and these are covered in MATM 3535. Taxpayers who question FTB's authority to demand information should be referred to R&TC §19504 (FTB's power to examine records) and the California Court of A*ppeal decision in Franchise Tax Board v. Firestone Tire and Rubber*, (1983) 139 Cal.App.3d 843, which upholds a trial court order enforcing an FTB subpoena and confirms that auditors have the right to photocopy information. If the taxpayer continues to be uncooperative after the auditor has issued a demand letter, the auditor and supervisor may seek the assistance of the Multistate Specialist and/or International Specialist to develop a joint plan of action.

In material cases, options for dealing with taxpayers include administrative subpoenas, and the penalties imposed under R&TC §25112 (water's-edge taxpayers) and R&TC §19141.6 (both water's-edge and worldwide taxpayers). Effective for taxable years beginning on or after January 1, 1994, if a taxpayer fails to maintain and make available upon request records pertaining to unity, business/nonbusiness treatment of income, apportionment factors or federal Subpart F or effectively connected income, R&TC §19141.6 will impose a penalty of $10,000 per taxable year. (An additional $10,000 may be imposed for each related party for whom the taxpayer fails to maintain records.) If the information is still not provided after 90 days, an additional $10,000 penalty will be imposed for each 30-day period during which the failure continues. The three-member franchise tax board must approve application of this penalty. Procedures for applying the penalty are explained in Chapter 20B, Water's-Edge Manual. Detailed regulations under R&TC §19141.6 were issued in April 1996, and should be reviewed before pursuing the imposition of the $10,000 penalty.

Reviewed: January 2004

3535 Failure To Furnish Information-Foreign Parent Situations

In the *Appeal of BSR USA, Ltd*. (Cal. St. Bd. of Equal., April 11, 1996), the SBE upheld the imposition of the failure to furnish information penalty against a foreign-owned taxpayer, concluding that the taxpayer had not shown reasonable cause for their failure. The SBE held the foreign-owned taxpayer to the same reasonable cause standard to which any other taxpayer would be held: the taxpayer must prove that they acted in the same manner as an ordinary, intelligent, and prudent business person would have acted under similar circumstances. In that case however, the taxpayer's actions had clearly established a pattern of "delay and misdirection." In less extreme cases, the extent to which FTB can enforce the penalty against taxpayers when information is under the control of uncooperative foreign parents is still untested. When contemplating failure to furnish information penalties in foreign parent situations, there are certain factors that auditors need to consider in addition to the normal guidelines and procedures set forth in MAPM 8040.

When setting a reasonable response time, auditors should consider the fact that the taxpayer may need to obtain translations if the data is in a foreign language.

If the requested information is not required to be collected or maintained by any U.S. or California record keeping requirement, then there may be reasonable cause for failing to provide the information if the taxpayer can demonstrate that the data does not exist, has been discarded in the normal course of business, or is otherwise not available due to circumstances beyond the control of the entity who had possessed the information. Record retention policies and indexes should be requested to verify the taxpayer's contentions. (This guideline applies to all taxpayers, not just those with foreign parents.)

FTB follows the federal policy that reasonable cause is not shown by the fact that the law of the foreign parent's country may impose civil or criminal penalties for disclosure of the information. (IRC §982(b)(2); also Committee Reports on P.L. 101-239 [OBRA 1989] in regard to the reporting requirements of IRC §6038A.) The department's position will be stronger if the purpose for the foreign law is commercial rather than for reasons of national security. Therefore, if the taxpayer brings up foreign law as a reason for not providing information, the auditor should document the foreign law asserted by the taxpayer, try to determine its purpose, and identify whether the nature of the potential penalty is civil or criminal.

The taxpayer should be asked to provide evidence of its attempts to obtain the information from the uncooperative foreign parent, as well as the foreign parent's responses to those attempts. This will not necessarily excuse the failure to provide information, but may give the auditor a more complete picture to evaluate for purposes of determining whether a penalty is appropriate. If possible, a written statement of the reason the foreign parent will not provide the information should be obtained. If the objection has to do with the costs of compliance, the potential inaccuracy that will result from not obtaining the information should be weighed against the costs of compliance. If the lack of information relates to an item with minor tax consequences, then no penalty should be imposed. On the other hand, if no valid reasons are given for the failure to provide information, then the penalty should be considered (but see the next item regarding taxpayers that are minor subsidiaries).

If the officers of the subsidiary are also officers of the parent corporation, then those individuals should be able to obtain the information.

The auditor should look for indications that the taxpayer is able to obtain information from its foreign parent when it suits its needs in the course of its business or in litigation. This may be detected through the corporate minutes or through a Lexis/Nexis search. Such information may impact the credibility of a taxpayer's argument that they are unable to obtain the information requested by the auditor.

If the foreign parent does not want its subsidiary to have the information, the auditor should have the taxpayer ask its parent to provide the information directly to FTB. The auditor may prepare a letter for the taxpayer to forward to the parent that explains that any information provided during the audit is confidential. (In this type of situation, the audit file should clearly identify the sensitive nature of the information.)

In cases where the above procedures have been exhausted, the auditor and supervisor may consider the possibility of pursuing a subpoena. Each office should have a copy of the subpoena guidelines. Note that the issuance of a subpoena does not diminish the department's authority to issue the penalty for failure to furnish information.

If the taxpayer questions FTB's authority for issuing a failure to furnish information penalty with respect to information that is in the hands of a foreign parent, it may be helpful to refer to R&TC §19504 (FTB's power to examine records) and to explain that foreign parents who choose to operate in California cannot use subsidiaries to shield themselves from the responsibility of providing unitary information. The California Court of Appeal has recognized that foreign-based unitary groups must furnish the same kind of information as domestic-based groups, and reasonable costs of complying with a particular jurisdiction's taxation scheme are costs inherent in doing business in foreign lands (*Barclay's Bank International v. FTB*, 10 Cal.App.4th 1742 (1992)).

Reviewed: January 2004

3540 SCOPING PROCEDURES

A unitary examination begins with the scoping process. As discussed in MATM 2400 - MATM 2445, a great deal of public information can be gathered during the preaudit stage. By scanning public documents such as annual reports and SEC Form 10-Ks, and by searching databanks such as Lexis/Nexis for articles on the taxpayer, auditors can gain some general knowledge about the business operations. Test checks can be prepared based upon the initial impressions formed during this process (MATM 2530). If the materiality of the issue warrants further investigation, the public documents may contain leads for areas in which to focus the examination.

Reviewed: December 2002

3545 UNDERSTAND THE TAXPAYER'S METHOD OF FILING

It is important to understand how the taxpayer filed, and what their basis was for that method of filing. Simply asking the taxpayer why they filed as they did, and confirming the response can sometimes resolve potential unitary issues identified during the preaudit phase.

The prior audit report may be a good source for historical information. Once the auditor has determined how the taxpayer was reporting or required to report in prior years, any changes in the method of reporting can be easily identified. Information from the taxpayer's prior years can also assist the auditor in planning the amount of time necessary to complete the audit. For example, where unity is being established for the first time or where the membership of the group has changed, it is likely that much more audit time will be required then would be the case if the auditor merely has to confirm that the unitary facts existing in a prior period are still present, and use those facts as a building block for the current audit.

Prior audit reports should be reviewed during the preaudit phase. Suggestions for performing this review are covered in more detail in MATM 2200. Occasionally, the current audit will indicate a unitary determination that is contrary to the department's position in a prior audit. This circumstance is discussed in MATM 3590.

Reviewed: December 2002

3550 EXAMINING UNITY OF OWNERSHIP

The requirements for unity of ownership are discussed in MATM 3050.

Ownership information should be obtained in any audit of a corporation. Identification of parent and subsidiary corporations is necessary in order to ascertain whether those entities should have been included in the combined report. Even if an individual or a nonunitary corporation holds the stock of the corporation, the auditor will need to identify whether that individual or corporation owns other corporations that may be combinable with the taxpayer.

Both the Federal Form 1120 and the California Form 100 require that the taxpayer indicate whether the same interests hold more than 50% of its voting stock. The SEC Form 10-Ks are required to contain an exhibit listing all significant subsidiaries of the filing corporation. This listing will usually identify whether the subsidiaries are owned more than 50%. Corporate directories such as Moody's will also contain such lists. The Federal Form 851 *Affiliations Schedule* will list the 80%-owned domestic subsidiaries and should also identify whether any changes in stock ownership occurred during the year. Additional techniques for identifying related corporations are also discussed in the sections of this manual describing the income reconciliation (MATM 5130) and the pre-audit procedures (MATM 2000 et al.).

Wholly owned and closely held corporations will keep records regarding the ownership of their stock. If control issues arise with respect to a corporation with a SEC filing requirement, the SEC Form 8-K may contain information that will be useful in determining whether unity of ownership is present. Whenever a change occurs in the control of a corporation registered with the SEC, a Form 8-K is required to be filed to report the details of the transaction and the basis for the control.

Corporations may have several classes of stock with differing voting rights. In such cases, auditors will need to analyze the relative voting power of each class of stock in order to determine whether common control exists.

Example 1
A corporation has two classes of stock; one of which has 10 voting rights per share and the other 1 voting right per share. Although an individual might not own over 50% of the stock, that individual could control the corporation by controlling over 50% of the voting rights.

Example 2
Corporation N has two classes of stock. Holders of Class A stock are entitled to elect just two of five members of the board of directors. Holders of Class B stock are entitled to elect the remaining three of the five directors. Individual X holds 500 shares of Class A stock, and unrelated individual Y holds

300 shares of Class B stock. No other shares are issued. Although X owns more than 50% of the stock, X cannot control the operations of Corporation N through election of the board of directors. The ownership requirement is therefore not met with respect to individual X.

The articles of incorporation will identify the various classes of stock. Since additional classes of stock may have been authorized after the original incorporation, any amendments to the articles should also be reviewed.

The corporate minute books may contain information regarding transfers of voting power or other factors that will affect the control of the corporation. If the auditor suspects that such agreements exist however, the details of the transaction will generally have to be obtained from the shareholders rather than from the corporation.

Reviewed: December 2002

3555 SEQUENCE OF UNITARY FACTUAL DEVELOPMENT

Factual development begins with obtaining a general familiarization with the business activities and operations (MATM 3560). Once auditors have this foundational knowledge of the taxpayer, it will be possible to target specific areas for more in-depth examination, and to develop specific requests for documentation that will form the basis for a unitary determination (MATM 3570, MATM 3575). Comprehensive written questionnaires and interviews may then be used to confirm or expand on the information that has been accumulated (MATM 3580). The questionnaires or interviews may also explore areas that were not adequately covered by other documents. Approaching the audit in this sequence will usually result in the most efficient use of resources.

Reviewed: December 2002

3560 UNDERSTAND THE TAXPAYER'S OPERATIONS

One of the first steps in any audit should be to become familiar with the taxpayer's operation. This involves asking questions such as:

- What do these companies do?
- What are the products and entities involved?
- Is there more than one business segment?
- Is the business organized in a divisional or multicorporate structure?
- What are the activities of each entity?
- What is involved in the major operations?
- What are the major operational decisions?
- Who are the key managers?

As this information is being obtained, the auditor should be thinking about the similarities or differences between the operations of the entities (or divisions), and the aspects of the operations where unitary ties might be expected to be present. An analysis of the background information should provide leads to follow in the unitary examination, and should enable the auditor to develop specific information requests that are tailored to the taxpayer's operations.

The initial interview with the tax department personnel is a good place to start becoming familiar with the taxpayer's business (suggestions for conducting this interview are in MATM 2730). Since the tax manager may not be knowledgeable about the way that the operations are conducted by the various entities however, it will probably be necessary to interview personnel that are involved in the operational side of the business.

Much of the background information can also be derived from organizational charts, annual reports, SEC 10-K Reports, company profiles, prior audit reports, magazine and newspaper articles (both about the corporations and about the key officers), and company publications and manuals.

As part of this audit step, the auditor should document the ownership and operational structure for the file. The following information should be listed for each entity:

1. The primary activities and products of the entity.
2. The location of the entity's operations.
3. The percentage of ownership and voting control.
4. Whether the entity has been recently acquired.
5. Whether the taxpayer included the entity in the combined report.
6. The names and positions of the directors and principal corporate officers. If the officers/directors changed during the audit period, this list should be prepared for each audit

year. (If there is a large group of subsidiaries, the auditor may choose to present this information only with respect to the principal subsidiaries.) To aid a reader in interpreting this information, the auditor may also prepare a summary highlighting the common officers and directors.

An ownership chart is very helpful for the file, particularly if it is a complex, tiered ownership structure. Charts showing the divisional structure and/or reporting lines of authority are also very useful.

Reviewed: December 2002

3570 GENERAL SOURCES OF INFORMATION FOR DETERMINING MANAGEMENT INVOLVEMENT AND OTHER UNITARY DATA

The degree of management involvement is a very subjective factor, and the development of facts necessary to establish the degree of management involvement is very resource intensive. A general understanding of the business, as discussed in MATM 3560, is the starting point for evaluating strong centralized management. Once this has been accomplished, the following sources may be examined for indications of the management activity that took place. By piecing together the individual fragments, the level of management involvement can be determined. Once the documentation has been examined, interviews of key officers will generally be necessary to tie together the pieces and to expand upon the auditor's findings.

Consolidated CPA Workpapers: CPA firms maintain audit files that could be of significant help in the development of unitary data. Since much of this information is also helpful for income and factor verification, review of these files should be done early in the audit. CPA workpaper files contain:

- Index: Each file will contain a master index that discloses what is contained in the file. The workpapers are numbered and cross-referenced.
- Consolidation files: The intercompany account analysis contained in the workpaper files may provide data important to a unitary analysis. The consolidation files will also be used for conducting the income reconciliation discussed in MATM 5130.
- Tax accrual files: The tax accrual workpapers are sensitive and need only be requested in rare circumstances.
- Administrative file: This file might be called the Permanent File or some other name depending upon the CPA firm. This file should include an overview of how the corporation is structured. There may also be an analysis of corporate minutes and extracts of significant comments, or a notation if no minutes exist.
- Management comment letters (These are not required, but may be present.)
- Financial statements by entity: These statements are generally prepared in-house and provided to the CPA firm as a starting point for their audit. This is a good source for by-entity information. The auditor should work off of the final statement that will reflect all closing adjustments (but the auditor should be sure to take into account any adjustments made during the CPA audit).
- SEC, Regulatory and Government filings
- Foreign Audits: Generally, information on foreign operations will also be in the files of the CPA firm. If a foreign CPA firm has performed the audit on subsidiaries, copies of their work will be in the files of the firm which signs the audited financial statements.
- Tax Return Workpapers: Workpapers used to prepare the tax return may be separate from the financial workpapers. Specific workpapers on Schedule M-1 items should be obtained for the M-1 analysis (MATM 5140).

One approach for reviewing this information is to request that the taxpayer contact the CPA firm and arrange for the auditor to visit the CPA firm to review the files. This will maximize the information that can be reviewed. Auditors might receive resistance to obtaining the CPA workpaper files, but we are entitled to them. (*U.S. v. Arthur Anderson & Co. et al*., 1980-2 USTC Para. 9515)

Corporate Minutes (Including All Committees) The minutes may reveal why major corporate actions have been taken, and why the organization is structured the way that it is. Centralized functions may be commented upon. The discussions of major policy decisions and the reports of segment managers may be helpful in ascertaining whether centralized management exists. Statements contained in the minutes will become building blocks for follow-up questions used in interviews of officers.

In addition to Board of Directors minutes, the auditor should review minutes of Committee & Sub-committee meetings. If the minutes are not very detailed, the agendas that are sent to the directors may be helpful.

Business Plans and Agenda Business plans and agendas provide insight into the degree of involvement of centralized management. Business plans may include strategic plans, budget plans, long-term plans, and mission & values statements.

Employee Communications In addition to information about general business operations, employee communications might be helpful in ascertaining the existence of employee transfers and management involvement in the various operations. Items to review include:

1. Bulletin announcements
2. Employee newsletters
3. Company orientation material/historical publications

Correspondence Files Correspondence files of key officers or managers should help determine the degree of management involvement in the various business segments. Because of the volume and sensitivity of this information, avoid making broad requests for correspondence files. Instead, request the entire correspondence files of specific individuals.

Manuals Manuals can provide information on the degree of centralized functions, common practices, and management involvement. A specific list of all manuals should be requested to insure that all manuals have been identified. When reviewing manuals, auditors should request the version that was in effect for the years under audit. If that version is not available, the auditor should ask the taxpayer to confirm or document whether the specific information relied upon from the manuals existed during the audit years.

1. Some types of manuals which taxpayers may have would include:
2. Policy and Procedure Manuals (these may include retention file requirements -- see MATM 3575)

3. Operating manuals such as:
    a. advertising
    b. accounting
    c. marketing
4. Forms Manual
5. Internal Audit Manual such as an Employee Handbook

Diaries, Calendars, Travel Expense Analysis Diaries and calendars of executives are useful in determining their involvement in the management of the various business segments. In addition, travel expense claims can help establish the location of travel and the purpose of the trips. Time reports might also be maintained to establish the amount of time that was spent on the various business segments. Airline manifests for company aircraft may also be helpful in this area.

Duty Statements of Key Officers and Management Personnel Duty statements will reveal the scope of authority and the responsibilities of the various officers. Some corporations may use employment agreements that will contain this information.

Court Actions Various court actions involving the taxpayer could provide information regarding the operations or about the inner workings of the company. Some of this information may be found in a Lexis search but a separate inquiry may also be made in this area along with a review of the annual report and SEC 10-K. Key officers or managers may be asked whether they have been deposed as to facts about company operations. If the answer is yes, the following steps should be undertaken:

1. Transcripts of testimony should be reviewed,
2. Depositions should be reviewed,
3. The nature of actions taken should be determined.

Deposition transcripts or exhibits are public in nature and not subject to the argument of attorney-client privilege.

Speeches Speeches given by executives at conferences, stockholder meetings or other business gatherings provide valuable insight into company operations. Through the interviewing process, inquiries may be made to help determine what speeches were given. Some of the areas to explore include:

1. Transcripts of shareholder meetings. Transcripts of the meeting might contain more information than the Shareholder Minutes themselves.
2. Newspaper articles
3. Inquire as to business conventions attended and determining whether speeches were presented.
4. Employee newsletters
5. Videotapes shown to employees
6. Conference agendas.

Conference Materials, Press Releases, Testimony Before Congressional or Regulatory Agencies These sources might be helpful in understanding the interactions between companies and involvement of management. The existence of such information might be identified through a Lexis/Nexis search.

Internal Audit Reports Internal audit reports can be a very helpful source of information. Reports issued to management will set forth the level of compliance with established company policy and procedures. The following information may be obtained:

1. Internal audit reports along with the report to management.
2. Size of the internal audit department. (The greater the size in relation to the business, the more likely greater internal controls will exist.)
3. Internal audit manuals and procedures.
4. Scope of duty of the internal audit department.
5. Reports other than internal audit reports, if any, generated by internal audit and their significance.

Electronic Mail Electronic mail is rapidly becoming a significant means of communication. This area should be explored to:

1. Establish whether electronic mail exists and if so, determine what exists and what is retained by data processing.
2. Determine which personnel have authorized access.

3. Determine levels of authorized access by officers and key managers.
4. Determine what hard copies are available.

Telephone Directory/Calls Made An examination of the telephone directory provides insight into overall company communications. A review of specific telephone bills for officers and key management personnel is of significant help in determining the amount of contact between organizations.

1. Obtain a company directory for years under audit.
2. Review telephone bills
3. Obtain information on faxes and telex's

Capital Expenditure Authorization Capital expenditure authorizations help determine the degree of centralized management. The policy and procedures manual should be reviewed to determine the levels of authorization and the approval procedures for capital expenditures. The approval limits at the subsidiary or divisional levels should be documented.

Visitor Logs An examination of visitor logs might be of assistance in determining which officers and key management personnel visited a particular entity. Although useful, such information is not necessarily complete because permanent passes might be held by many key personnel who are not required to sign the visitor log.

1. Determine dates visits were made.
2. Determine who made the visits and use this data to check travel expense claims for establishing the purpose of the visit.
3. Determine who had been issued permanent passes and would not have signed in on visitor logs.

Management Fee Allocation Workpapers Management fee allocations can be used for determining centralized management involvement.

1. Identify the amount of charges made to the specific subsidiary.
2. Analyze the charges to determine the components of the management fee.
3. Determine how the management fee is calculated.

Regulatory Reports Regulatory reports required to be filed with various federal and state agencies can provide extensive information as to the background and operations of the company as well as financial information that will be useful for examining income, apportionment factors and other issues. Some types of regulatory reports are specific to an industry (i.e., banks are regulated by the FDIC and state banking agencies; electric companies are regulated by the Public Utilities Commission, Airlines are regulated by the Federal Aviation Administration, etc.). Other reports are required when a corporation takes certain actions. (For example, when large corporations are involved in mergers or acquisitions, they may file extensive information with the Federal Trade Commission pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976. Information provided by such filing includes details of intercompany sales, product lines, locations of factories, a description of the acquisition, and studies, surveys, analysis and reports prepared for the purpose of evaluating the acquisition.)

Reviewed: December 2002

3575 SUGGESTED AREAS OF UNITARY DEVELOPMENT

In addition to management involvement (discussed in MATM 3570), the following suggested areas of development might be applicable to large corporations. Not all of this information will be necessary (or relevant) in every audit. On the other hand, many taxpayers may have documentation or unitary features that are not covered by this list. This list is intended only as a guide for auditors to tailor to the specific circumstances of their audit.

It is important to understand the record retention practices of the organization. Most large organizations will have a retention file listing the records that are retained, and the location of those records. This can be valuable for identifying documents that will aid in the factual development. Unitary relationships are not always uniform throughout an affiliated group. Therefore, when developing facts involving multiple entities, it is important to identify which facts apply to which entities. For example, if a parent corporation provides a centralized service, the audit narrative should specify which entities used that service, and to what extent.

Intercompany Sales and Services

1. Review the intercompany accounts in the detail general ledger to determine the items, which are being charged to those accounts.
2. Identify the significance of the items that are sold intercompany (e.g., are they essential components of the purchasing company's product, can they be obtained from other sources, etc.).
3. For both the selling company and the purchasing company, list both the amounts of intercompany sales (purchases) for each year, and the percentage that those amounts bear to total sales (purchases) of the company. (This information will also be useful in verifying the sales factor -- see MATM 7518.)
4. Take a "big picture" look at the intercompany transactions occurring between all members of the group. Transactions that might seem minor when taken in isolation may acquire significance when viewed in conjunction with other transactions.

Technical Service or Licensing Agreements

Whether or not agreements have any unitary significance depends upon their importance to the business of the corporations involved. In order to understand the significance of such agreements, the auditor should develop information such as the following:

1. Percentage of licensee's sales that is based on the license.

2. Purpose for the stock ownership of the licensee, for example a pre-condition for the agreement.
3. Other indicia of an operational relationship such as the number of visits from the licensor to the licensee or vice versa, the level and amount of product review and exchange of a technical/marketing information, and whether the two companies have common directors and common officers making operational decisions for the licensee.

Personnel Transfers/Hiring

The movement of personnel between corporations is one element of unity. In order to understand the process and determine the records that should be reviewed, interviews with Personnel Managers may need to be conducted. Based upon the information developed, the auditor should:

1. Review employee newsletters for hiring and transfer disclosures.
2. Develop employment dates, positions and employment history of officers and key management individuals (sometimes this information is summarized in annual reports or SEC Forms 10-K).
3. For transfers within the audit period, determine the old and new position and corporation.
4. Obtain the total number of employees and compare to the number of transfers to determine significance.
5. Evaluate the personnel level and classification of the transfers to determine the level of training and expertise that is being transferred along with the employee.

Research and Development

Common research and development can be an important element of unity. Before developing this element, it is important to have an understanding of the operations, as well as the products and processes that are involved. An interview with the R&D manager is a good first step in developing this area.

1. Determine licensing arrangements between parent and subsidiaries.
2. Obtain a list of issued patents and pending patents and determine whether these are being used within the group.
3. Determine whether R & D departments exist at subsidiary levels and determine their functions.
4. Determine the R & D expenditures by entity.
5. Determine how R & D is funded.

Marketing

Marketing of company products is a very significant element of unity.

1. Interview the marketing manger to determine how the operation functions.
2. Determine whether there are central distribution facilities.
3. Determine how the channels of distribution function.
4. Obtain master customer lists and identify significant common customers.
5. Determine whether common logos and trademarks are being used.
6. Determine whether there are common procedures for customer relations, discounts, etc.
7. Determine whether there is a common sales staff.
8. Determine who generates sales literature, catalogs, etc.
9. Determine if there is a central 800 number for placing orders for parent and subsidiary products.
10. Determine who authorizes returns.
11. Determine how pricing strategies are determined.
12. Examine major marketing contracts.
13. Examine the sales commission structure to determine whether the parent's sales force is compensated for products sold belonging to subsidiary.

Centralized Purchasing

Centralized purchasing of major raw materials is a significant item, while the purchasing of more incidental items such as office supplies, rental cars or employee group discounts carries much less importance in a unitary context.

1. Determine whether a centralized purchasing department exists.
2. If the business segments use similar materials, but no centralized purchasing department is evident, supplier lists may be requested to determine whether common suppliers are used. For smaller operations, purchase invoices may be sampled to obtain this information.
3. If centralized purchasing or common suppliers are present, determine whether volume discounts result.
4. Determine whether centralized purchasing is operational (raw materials) or incidental (supplies, etc.).
5. Determine the types of national purchase contracts that exist.
6. Determine whether purchasing is required from an approved list of vendors.
7. Review policy manuals for requirements relating to purchasing.
8. Review purchase order requirements.
9. Determine who negotiates the terms for purchasing.

Intercompany Financing

Remember that intercompany financing used to further diverse businesses is not a significant item unless that financing serves to further a unitary cause (see MATM 3040). The detail general ledger can be reviewed to identify intercompany loan accounts. The loan files and the company's policy for intercompany financing may then be inspected to determine additional information. Items of inquiry would include:

1. Determine amounts advanced and repaid during year.
2. Identify amounts, terms and entities involved in intercompany financing.
3. Identify borrowing authorizations and restrictions.
4. Identify guarantees and collateral used.
5. Identify how excess funds are handled.
6. Identify uses and sources of funds.

Treasury Review

Many companies maintain Treasury Policy and Procedures manuals, which will provide information regarding the treasury function. The manager of the treasury department may also be interviewed to determine how the treasury function is operated. Information that should be obtained includes:

1. Determine how the cash management program functions.
2. Determine the types of financial reports that are required to be submitted.
3. Determine reporting controls on divisions and subsidiaries.
4. Determine the independent borrowing capacity of divisions or subsidiaries.
5. Determine how letters of credit are obtained and what securities are pledged.
6. Determine how credit is extended to major customers and who has the responsibility for this function.

Physical Facility Use

Sharing of common facilities is an element of unity. Steps to develop this item include:

1. Obtain a directory/location of corporate facilities.
2. Review facility use plans and determine who performs this function.
3. Determine whether there is a centralized real estate department, and what its functions are.
4. Determine which facilities are commonly used.
5. Determine who has the function of approving real estate leases.

Employee Benefits

1. Obtain an employee handbook, which explains benefits.
2. Determine which benefits are common throughout the organization.
3. Determine which benefits are not common throughout the organization.
4. Determine whether profit sharing exists and if so, how it is determined.

5. Determine whether stock bonus plans are paid with stock of the parent or subsidiary.

Advertising

1. Interview the advertising manager and determine how the operation functions.
2. Determine if there is a centralized advertising department
3. Determine whether advertising is done on an international, national, or local basis. To the extent that advertising is not uniform throughout the markets served by the affiliated group, are there similarities as to advertising format, target market, common advertising agency, etc? Sample advertisements or advertising contracts from different geographic areas may be used to obtain this information.
4. Obtain copies of advertisements from different business segments to determine whether they stress corporate or subsidiary identity.
5. Obtain product brochures to determine whether uniform trademarks, tradenames, or logos are used.
6. Contrast subsidiary advertising cost with parent cost.

Accounting

Depending upon the nature of the activity, accounting may be a significant item if centralized bookkeeping types of services are provided. Items pertaining to the preparation of audited financial statements or consolidated federal tax returns are common to all investments and would not be a significant item. In order to evaluate this area,

1. Interview the controller or accounting manager to determine what operations are centralized.
2. Identify the records that are created
3. Review the Accounting Procedures Manuals
4. Determine the standard forms that are utilized
5. Determine reporting requirements of subsidiaries.
6. Determine collection procedures and establish who performs this function.

Insurance Review

1. Interview the risk assessment/insurance and loss control manager to determine the workings of the insurance department.
2. Determine common coverage.
3. Determine separate coverage.
4. Determine whether a centralized insurance department exists.
5. Determine whether the company is self-insured.
6. Document the savings from common coverage. Letters from the insurance agent to the company may set forth such savings.

Legal Department Review

1. Determine whether a centralized legal department exists.
2. Determine the number of staff at corporate level.
3. Determine the number of staff at operating level.
4. Determine the degree to which outside counsel is used and for what items.
5. Determine whether the inhouse legal staff is acting in an advisory capacity or an operational role. Does this role differ at the corporate level versus the operating level?
6. Ascertain benefits involved in using inhouse versus outside counsel. In addition to cost savings, benefits may take the form of specialized knowledge or expertise regarding the company's legal environment.
7. Review the inhouse billing invoices to determine the types of services that were provided and how those services were billed.

Labor Relations

1. Interview the labor relation's manager and determine the department's function.
2. Determine who negotiates union contracts.
3. Determine if there is a centralized department dealing with labor relations such as EEOC.
4. Determine how employee grievances are handled.
5. Review employee personnel and hiring procedures and determine whether this function is centralized.

Management Information Systems (Computers)

Management Information Systems (MIS) provide a significant amount of computerized information for the organization. This area would be explored by:

1. Determining what the MIS system is and what reports are generated by interviewing the MIS manager.
2. Determine whether there is a central data processing center. (If there is more than one computer facility, identify the services that are provided at each location.)
3. Determine whether there is a central programming staff.
4. Determine whether there is a central software development center.
5. Determine whose tasks/projects are performed by the data processing center.
6. Determine how requests are referred to MIS.
7. Explore how hardware requirements are determined.
8. If subsidiaries maintain their own computer facilities, identify the services provided by those facilities. Explain the extent to which each of the subsidiary computer facilities is tied in with the parent's (or another subsidiary's) computer system to receive or exchange particular data.

Training

Corporations may provide training to their employees through either training programs (such as management development or sales training) or manuals (for example, a training manual on internal accounting procedures). To develop this issue, the auditor must first determine what types of training programs or manuals the corporations use. The auditor must then develop the following information:

1. Obtain a list of training courses given.
2. Determine the nature of the training (management or technical).
3. Determine which personnel classifications attend the training.
4. Determine which subsidiaries send personnel to the training (or use the manuals).
5. Obtain names and history of the training staff.
6. Determine whether a centralized training facility exists.

Other State Audits

The results of audits done by other states may be requested. Although not controlling, such information might be useful in deciding whether supplied facts are consistent from state to state.

Reviewed: December 2002

3580 INTERVIEWING KEY EMPLOYEES

An important technique for developing information about a corporation's management and operational structure is to interview key employees. Tax managers frequently will not know the answers to questions about the various functions of the organization. Since the answer to one question will often generate other questions, written questionnaires can in many cases be an inefficient way to develop the information.

Since tax managers may be reluctant to allow the auditor to go outside the tax department for information, the auditor may have to be insistent about interviewing employees. Tax managers generally have responsibility for maintaining control over the audit, however they *should not be allowed to maintain control over the type or source of information necessary for resolving the audit*. Auditors should explain to the tax manager why the interviews are necessary, and should be flexible in order to minimize the inconvenience to the taxpayer. For example, it may be necessary for the auditor to travel to a subsidiary's location to interview an employee that does not work at the headquarters office. Alternatively, the auditor may consider scheduling a telephone interview.

In order to examine many of the key operational functions described in MATM 3575, it is necessary for the auditor to gain an understanding first of how the function is performed, and what types of documents or reports are available. This information is usually most efficiently obtained through an interview with the manager in charge of the function. For example, the development of facts concerning the research and development function might start with an interview of the R&D manager. The auditor should prepare for the interview by compiling a list of general questions such as what type of research is performed, what are the applications of that research to the various products produced by the group of corporations, what products or processes have been developed, which entities have directly benefited from the research, is all the research performed at one location or is there more than one research facility, what are the channels for a subsidiary to request a specific type of research project, what are the channels for research developments to be shared with the operating entities, how are the subsidiaries charged for R&D, what types of reports are generated by the R&D department, etc. The responses to these general questions will undoubtedly lead to additional, more detailed questions.

Sometimes, interviews will be held after the initial fact gathering process is completed rather than as a preliminary step in the factual development. The purpose of these types of interviews is to tie together and expand upon the facts that have been obtained, or to resolve apparent conflicts in information that has been developed. Interviews of key officers to determine the presence of strong centralized management will fall into this category. The types of questions asked in these interviews are based upon the auditor's analysis of the documents that have previously been obtained. Since the auditor will be asking the interviewee to comment specifically on the documentation, the auditor should prepare carefully for the interview and may consider presenting the interviewee with examples of the items upon which they will be asked to comment.

Generally, the persons to be interviewed in connection with an evaluation of strong central management should be in charge of the companies under examination, be a common manager, or have knowledge concerning a potentially common department. Questions to ask someone from a potentially central department should address the nature of the services provided to the various entities in question. Other questions for potentially central managers could include: what is the interviewee's background, work experience, where do they fall in to the chain of command, etc; what is the person's area of responsibility and how is it performed in conjunction with other managers; how are differences and disagreements resolved between entities (examples should be requested); what are examples of major accomplishments or major decisions that cut across corporate entities; what types of decisions made by the subsidiary were overridden by the parent; and any other questions that will determine if the manager had a regular, operational role in the affairs of a subsidiary. If conflicting information was developed during the audit, the interviewee should be asked to resolve it.

Some techniques for conducting successful interviews are as follows:

Prior to the interview:

1. Obtain function descriptions and job descriptions of the relevant areas to determine who should be interviewed.
2. When selecting individuals to interview, ask if they were in their present position during the audit years. If the current manager of a department was not involved with that department during the audit years, it may be preferable to interview a former manager or another employee who is knowledgeable about that department's operation during the relevant time period.
3. Whenever possible, schedule interviews in the morning and leave the afternoon free to write up the summary of the interview while the conversation is still fresh in your mind. If you must interview two people on the same day, schedule the interviews so that there will be ample time in between to expand or clarify your notes.
4. Prior to the interview, ask the taxpayer if the interview can be recorded. This will enable you to concentrate on the interview rather than on note taking. Most taxpayers will not object to the recording as long as they receive a copy of the tape.
5. Consider scheduling a tour of the facilities relating to the job function prior to the actual interview. By obtaining a general understanding of the function, specific questions can be framed, and the responses can be placed into perspective.

During the interview:

1. At the beginning of the interview, emphasize that the responses should reflect the facts as they existed during the audit years. It may be necessary to remind the interviewee of this focus during the conversation.
2. Obtain the names of relevant documents and reports so that you can later confirm the interviewee's statements.
3. Ask whether you may contact the interviewee directly to ask any follow-up questions. Some taxpayers prefer that such inquiries be first directed to the tax manager.

After the interview:

1. As soon as possible, prepare a summary of the interview from your notes or from the tape recording.
2. The summary of the interview should identify the name, position and area of responsibility of the person interviewed. To establish the credibility of the responses, it is also a very good idea to record the length of time that the individual has been in their present position, and any other positions that they held with the company.
3. Ask the interviewee to sign the summary after reviewing it for accuracy. This will prevent misunderstandings from arising over what was said.
4. Request documentation to confirm important information obtained orally during the interview. If any of the documentation conflicts with the information obtained during the interview, ask the interviewee to explain the discrepancy.

Reviewed: December 2002

3590 CHANGE IN POSITION FROM PRIOR YEARS AUDIT

Occasionally, the findings in a current audit will indicate a determination that is contrary to the position taken by the department in an audit of prior years. The interpretation of a taxpayer's unitary facts should be applied consistently from year to year. Consequently, a change in position from the prior audit is not a decision that should be taken lightly. On the other hand, there are circumstances where such a change is appropriate.

A taxpayer's method of filing is sometimes either allowed or adjusted by auditors based upon insufficient evidence (such as when an audit is closed as a result of a taxpayer's failure to furnish information or when an NPA is issued due to an impending SOL). In other cases, the prior audit determination may have been based upon theories that have been invalidated by the SBE or Courts (for example, many audits completed in the past denied combination based solely upon the lack of functional integration). If the current audits of these taxpayers indicate the taxpayer's method of filing to be improper, it is essential that the auditor make the necessary changes to place the taxpayer on the correct method of filing.

It is also possible that facts have changed from the prior audit that will clearly indicate a change in the filing requirement. The auditor must document these changes in detail within his audit report. It is very important to note the dates that significant events occurred.

Most of these cases are not black or white situations. Before the auditor makes a change in the filing method, a thorough discussion of the facts should be held between the auditor and supervisor.

Reviewed: December 2002

3595 HOW TO PROCEED AFTER A REFUND IS DETECTED

If the taxpayer has not been contacted:
Whenever possible, the auditor will perform a test check prior to the audit appointment to determine if a combination or decombination of a group of taxpayers will result in a refund (see MATM 2530). If the unitary issue will produce a refund but the auditor is not certain that the issue will be resolved in the taxpayer's favor, then the auditor may still continue with the audit of other items in the tax return. If the decision is made to pursue the audit however, the taxpayer *must* be notified that the potential for a refund exists and that they have the burden of developing the unitary facts and figures if they so choose (a specific time frame should be established for a reply).

If the taxpayer has been contacted:
There are occasions when the potential for a refund is not detected until the taxpayer has been contacted. Since one of the department's primary responsibilities is to perform audits on an equitable basis, the taxpayer must be notified that preliminary audit work uncovered the possibility of a refund. The taxpayer should be informed that if they wish to pursue the refund, they have the responsibility of developing the unitary facts.

If the auditor is not certain that the unitary issue will be resolved in the taxpayer's favor, then the auditor may still continue with the audit of other significant items in the tax return.
If the known facts *clearly* indicate that the method of filing which would generate the refund is correct, but the taxpayer for whatever reason expresses no interest in pursuing the refund, then the other audit issues should generally not be adjusted unless the tax potential of those issues is materially greater than the potential refund. (Even if the auditor is certain that a unitary relationship exists, it is not necessary to develop the taxpayer's refund if substantial effort will be required to put together the necessary numbers.) Any unadjusted issues should be disclosed in the narrative for further follow-up in the event the taxpayer subsequently decides to file a claim for refund. In all cases, Revenue Agent's Reports should be forwarded to central office for adjustment.

MAPM 6050 contains examples of letters to notify taxpayers of potential refunds ("Walker letters"). It is important that the auditor adapt the letters to the situations. For example, if the auditor has not yet begun to examine the unitary relationship of the corporations, the letter should not state that unity appears to exist. It should instead be stated that no determination has been made as to the unitary relationship of the corporations.

Reviewed: January 2004